

**TENNESSEE DEPARTMENT OF REVENUE
REVENUE RULING # 04-15**

WARNING

Revenue rulings are not binding on the Department. This presentation of the ruling in a redacted form is information only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Departmental policy.

SUBJECT

Whether a provider of temporary labor services to certain clients is making retail or wholesale sales for purposes of the Tennessee business tax and whether gross receipts from certain services provided are exempt from the tax.

SCOPE

Revenue rulings are statements regarding the substantive application of law and statements of procedure that affect the rights and duties of taxpayers and other members of the public. Revenue rulings are advisory in nature and are not binding on the Department.

FACTS

The Taxpayers are two legal entities. One is a corporation organized under the laws of a state other than Tennessee. The other is a limited partnership organized under the laws of a state other than Tennessee.

The Taxpayers are providers of mass-customized contract staffing services to unrelated businesses located both within and without Tennessee. Because both entities provide identical services and conduct their business in a similar fashion, they hereinafter will be referred to as the "Taxpayer."

The Taxpayer represents to the public at large that it is a provider of temporary labor services. It does not advertise the specific services (i.e. word processing, data entry, accounting, auditing, etc.) that may be performed by an employee that it provides. Although employees provided are subject to the Taxpayer's management, the services that such employees perform are done pursuant to job title descriptions that the Taxpayer's customers provide.

Employees of the Taxpayer provide both skilled and unskilled temporary labor services to a wide range of businesses, including manufacturers, wholesalers, retailers and

service providers. The Taxpayer categorizes its service offerings into four core practice areas as follows:

1. Office talent, which is provided principally by unskilled laborers and includes such positions as administrative assistants, general clerical services, data entry clerks, switchboard operators, accounting clerks, receptionists, and word processing specialists.
2. Industrial talent, which includes both skilled and unskilled laborers and includes such positions as mechanics, truck drivers, forklift operators, material handlers, skilled technicians (i.e. electricians), assemblers and packers.
3. Technical services, which are generally provided by highly skilled employees and include CAD/CAM services, biomedical technicians, computer programmers, laboratory assistants, and analysts.
4. Professional resources, which include paralegal support, human resource services, skilled accounting positions such as internal auditors, controllers, and account specialists.

Substantially all of the above-referenced service categories are provided to businesses located within Tennessee. The Taxpayer's Tennessee customer base is extremely broad and includes businesses of all types including, but not limited to, manufacturers, retailers, wholesale distributors of tangible personal property, financial institutions, insurers, real estate developers, agricultural operations, medical and health institutions, state and local government agencies, educational institutions, charitable organizations and miscellaneous service providers.

No one customer serves as the source of a majority of the Taxpayer's revenues; however, a review of 2003 gross receipts by customer shows that a majority of the Taxpayer's revenues appears to have been derived from customers engaged in the manufacture of tangible personal property.

The Taxpayer's fees are based on the classification of the employee and the nature of the services provided. Fees are billed on an hourly basis and each employee is required to report his/her charged hours to the Taxpayer. Accordingly, the Taxpayer does have the capability to separately account for fees based upon the identity of the customer and the nature of the services provided.

The Taxpayer classifies its temporary labor services into the following categories:

1. Those wherein the employee provides general and administrative services (i.e., a receptionist or word processor) to a client engaged in a service business (i.e., a non-seller of tangible personal property). The client's service business is different from the service business of the Taxpayer and services provided by the

client are not the same services that the client is purchasing from the Taxpayer. (i.e., the client is not providing receptionist or work processing services.)

2. Those wherein the employee provides services to a client engaged in a service business (i.e., a non-seller of tangible personal property). For example, the Taxpayer's employee is a draftsman that provides such services to an architectural firm.

3. Those wherein the employee provides general and administrative services to a client, other than a manufacturer, engaged in the retail or wholesale sale of tangible personal property.

4. Those wherein the employee provides services to a client, other than a manufacturer, engaged in the retail or wholesale sale of tangible personal property and such services involve the preparation and/or distribution of the client's goods for sale or resale. The Taxpayer gives the following examples of services in this category: (1) warehouseman; (2) forklift operator; (3) packing and shipping clerk; (4) stock clerk.

5. Those wherein the employee provides general and administrative services to a client engaged in the manufacture of tangible personal property for sale at retail or wholesale.

6. Those wherein the employee provides services to a client engaged in the manufacture and/or process of the client's goods for sale or resale. The Taxpayer gives the following examples of services in this category: (1) production line operator; (2) production line supervisor; (3) material handling equipment operator; (4) product designers; (5) quality control personnel; (6) packer and shipper; (7) repair and maintenance personnel to the extent that they repair or maintain manufacturing machinery; (8) assembler; (9) production equipment operator.

For purposes of this Revenue Ruling, it is assumed that the Taxpayer is located in a Tennessee city and/or county that has levied a business tax in accordance with Tenn. Code Ann. § 67-4-701 et seq.

QUESTIONS PRESENTED

1. Under what circumstances should the gross receipts of a provider of temporary labor services be considered "wholesale sales" for purposes of determining the appropriate rate of business tax pursuant to Tenn. Code Ann. § 67-4-709(b)(3)(B)?

2. Is the provider of temporary labor services that qualify as an exempt activity pursuant to Tenn. Code Ann. §§ 67-4-708(3)(C)(i)-(xv) exempt from payment of Tennessee business tax on gross receipts derived from providing such services?

RULINGS

1. (a) Gross receipts from general and administrative services (i.e., a receptionist or word processor) that the Taxpayer's employee provides to a client engaged in a different service business (i.e., a non-seller of tangible personal property) are from retail sales and are subject to the three sixteenths of one percent (3/16 of 1%) business tax rate under Tenn. Code Ann. § 67-4-709(b)(3)(A).
- (b) Gross receipts from services (i.e. a draftsman that provides services to an architectural firm) that the Taxpayer's employee provides to a client engaged in a service business (i.e., a non-seller of tangible personal property) are from retail sales and are subject to the three sixteenths of one percent (3/16 of 1%) business tax rate under Tenn. Code Ann. § 67-4-709(b)(3)(A).
- (c) Gross receipts from general and administrative services that the Taxpayer's employee provides to a client, other than a manufacturer, engaged in the retail or wholesale sale of tangible personal property are from retail sales and are subject to the three sixteenths of one percent (3/16 of 1%) business tax rate under Tenn. Code Ann. § 67-4-709(b)(3)(A).
- (d) Gross receipts from services (i.e. services of a warehouseman, a forklift operator, a packing and shipping clerk, or a stock clerk) provided by the Taxpayer's employee to a client, other than a manufacturer, who is engaged in the retail or wholesale sale of tangible personal property and that involve the preparation and/or distribution of the client's goods for sale or resale, are used and consumed by the Taxpayer's client and are retail sales subject to the three sixteenths of one percent (3/16 of 1%) business tax rate under Tenn. Code Ann. § 67-4-709(b)(3)(A).
- (e) Gross receipts from general and administrative services that the Taxpayer's employee provides to a client engaged in the manufacture of tangible personal property for sale at retail or wholesale are being consumed by the client to whom they are sold rather than being resold, leased or rented by such client and are from retail sales subject to the three sixteenths of one percent (3/16 of 1%) business tax rate under Tenn. Code Ann. § 67-4-709(b)(3)(A).
- (f) Gross receipts from services (i.e. services of a production line operator, a production line supervisor, a material handling equipment operator, a product designer, a quality control person, a packer and shipper, a repair and maintenance person¹, to the extent that he repairs or maintains manufacturing machinery, an assembler, or a production equipment operator) that the Taxpayer's employee provides to a client engaged in the manufacture and/or

¹ Depending on the circumstances, machinery and equipment used to perform some of the services listed may not necessarily qualify as exempt industrial machinery for Tennessee sales and use tax purposes.

process of goods for sale or resale are considered wholesale sales by Tenn. Comp. R. & Regs. 1320-4-5.29(1) and are subject to the business tax rate of three eightieths of one percent (3/80 of 1%).

If the Taxpayer is primarily making wholesale sales but makes more than 20% of his sales at retail, then the wholesale sales are subject to the business tax rate of three eightieths of one percent (3/80 of 1%) and the retail sales are subject to the three sixteenths of one percent (3/16 of 1%) business tax rate.

If the Taxpayer makes 20% or less of his sales at retail, then gross receipts from all sales, both wholesale and retail are subject to the business tax rate of three eightieths of one percent (3/80 of 1%).

If the Taxpayer is primarily making retail sales but makes more than 20% of his sales at wholesale, then the retail sales are subject to the three sixteenths of one percent (3/16 of 1%) business tax rate and the wholesale sales are subject to the business tax rate of three eightieths of one percent (3/80 of 1%).

If the Taxpayer makes 20% or less of his sales at wholesale, then gross receipts from all sales, both wholesale and retail are subject to the three sixteenths of one percent (3/16 of 1%) business tax rate.

2. If a fee received by the Taxpayer for temporary labor services can be segregated and identified as having been generated solely by a particular employee's performance of a service that is exempt from the Tennessee business tax, then the fee will be exempt from the tax.

ANALYSIS

The Taxpayer's Dominant Business Activity is Making Sales of Services and Engaging in the Business of Furnishing or Rendering Services

The Business Tax Act, found in Tenn. Code Ann. §§ 67-4-701 et seq., is a component of Tennessee's scheme of privilege and excise taxes. Tenn. Code Ann. § 67-4-704(a) allows counties and incorporated municipalities to tax the privilege of:

“ . . . the making of sales by engaging in any . . . business activity enumerated . . . in § 67-4-708(1)-(3).”

The Taxpayer describes itself as a provider of “. . . temporary labor services to a variety of business clients. . . .”

Tenn. Code Ann. § 67-4-708 classifies businesses according to their “dominant business activity,” and these statutory classifications determine the tax rate. The

“dominate business activity” of a business is defined by Tenn. Code Ann. § 67-4-702(4) to mean:

“. . . the business activity which is the major and principal source of gross sales at retail and the major and principal source of gross sales at wholesale of the business.”

Tenn. Comp. R. & Regs. 1320-4-5-.15 makes the following comments with regard to the term “dominant business activity”:

“For purposes of the business tax both wholesale and retail businesses are classified according to their dominant business activity. The item comprising the largest proportion of gross sales of the business when compared with other items sold determines its classification. A business may be taxed at both retail and wholesale rates but only one classification (of Classifications 1, 2, 3 or 4) shall apply. Once the classification is determined, the gross sales of the business or the proportionate part of the receipts applicable to both wholesale and retail sales, if liability exists under both types of business, are taxed at the rate specified by such classification. The fact that sales may be made at both wholesale and retail shall have no effect in determining the dominant business activity.”

Tenn. Code Ann. § 67-4-708 provides five business classifications for purposes of being subject to the business tax and for purposes of determining the appropriate tax rate to be applied to the taxpayer’s gross receipts. Under classification 3, Tenn. Code Ann. § 67-4-708(3)(C) applies the business tax to the:

“. . . making of sales of services or engaging in the business of furnishing or rendering services . . .”

“Services” are defined by Tenn. Code Ann. § 67-4-702(18) to mean and include:

“. . . every activity, function or work engaged in by a person for profit or monetary gain except as otherwise provided in this part.”

Tenn. Comp. R. & Regs. 1320-4-5-.48(1) states that the term “services” includes:

“. . . all activity, functions or work engaged in by one person for another person for a consideration. The term ‘services’ shall not include sales of tangible personal property.”

Tenn. Comp. R. & Regs. 1320-4-5-.48(2) further provides that:

“All persons engaged in the business of rendering services are liable for the business tax unless specifically exempted under the provisions of § 67-4-708,

T.C.A., classification 3 [now Tenn. Code Ann. § 67-4-708(3)(C)(i)-(xv)] of the Business Tax Act.”

The Taxpayer describes itself as a provider of “. . . temporary labor services to a variety of business clients. . .” Clearly, Tenn. Code Ann. § 67-4-708(3)(C) places the taxpayer under classification 3 since its dominant business activity is the rendering of services.

The Taxpayer’s Business Tax Rate Depends on Whether
Its Receipts are from Retail or Wholesale Sales

Tenn. Code Ann. § 67-4-709(b)(3) subjects a classification 3 taxpayer to one of the following two tax rates, depending on whether its sales are wholesale or retail in nature:

“(A) Three sixteenths of one percent (3/16 of 1%) of all the retail sales of the business; and

“(B) Three eightieths of one percent (3/80 of 1%) of all the wholesale sales of the business.”

The term “retail sales” is defined by Tenn. Code Ann. § 67-4-702(a)(13) as follows:

“ ‘Retail sales’ or ‘sale at retail’ means a sale of . . . services rendered to a consumer or to any person for any purpose other than for resale, and means and includes all such transactions as the commissioner upon investigation finds to be in lieu of sales; provided, that sales for resale must be in strict compliance with rules and regulations. Any person making a sale for resale which is not in strict compliance with rules and regulations shall personally be liable for and pay the tax . . .”

Tenn. Code Ann. § 67-4-702(a)(21) defines the term “wholesale sale” as follows:

“ ‘Wholesale sale’ or ‘sale at wholesale’ means the sale of . . . services rendered in the regular course of business to a licensed retailer for resale, lease or rental . . . in the retailer’s regular course of business to a user or consumer. The quantity of property sold or the price at which the property is sold is immaterial in determining whether or not the sale is at wholesale . . .”

Tenn. Comp. R. & Regs. 1320-4-5-.47(1) sheds additional light on the distinction between retail and wholesale sales as follows:

“(1) Sales for resale include those whereby a supplier of . . . services makes such . . . services available for further processing as a component part of a product to legitimate dealers engaged in and actually reselling or leasing such . . . services to a user or consumer. . . .

“(2) Sales of . . . services to a licensed retailer who may make further distributions from a central warehouse or other distribution point to others for resale shall be deemed to be wholesale sales, and the licensed retailer shall be

liable for wholesale tax on any such distributions if receipts from such exceed 20% of his total sales.”

A business can be subject to both the retail business tax rate and the wholesale business tax rate. Tenn. Comp. R. & Regs. 1320-4-5-.37 makes the following provisions in this regard:

“(1) A person whose business is primarily that of making wholesale sales but who makes more than 20% of his sales at retail is liable for both the wholesale and retail business tax at the appropriate rates on each category of such sales. If the person makes 20% or less of his sales at retail, he is liable for the business tax at the appropriate wholesale rate on all his sales, both wholesale and retail. (Either category shall be based on net taxable sales after allowable deductions.)

“(2) A person whose business is primarily that of making retail sales but who makes more than 20% of his sales at wholesale is liable for the business tax at the appropriate retail rate on the sales, and at the appropriate wholesale rate on the wholesale sales. If the person makes 20% or less of his sales at wholesale, he is liable for the business tax at the appropriate retail rate on all of his sales, both retail and wholesale.”

Application of Statutes and Rules to Determine Whether the Taxpayer’s Sales of Services are Wholesale or Retail

In determining whether a sale is for resale, crux of the issue is whether the vendee is the consumer of the items sold by the vendor or whether the vendee’s customer is the consumer. The question becomes, is the taxable service being sold for consumption by the buyer, or for resale by the buyer? (See: Tenn. Op. Atty. Gen. No. 84-043, WL 186136, (Jan. 31, 1984)²

However, we must keep in mind that, in any case, Tenn. Comp. R. & Regs. 1320-4-5-.29(1) provides that:

“Sales of . . . services to manufacturers and processors who . . . use the services in preparing such product for sale or resale, are considered to be sales at wholesale . . .”

In order to determine whether the Taxpayer’s gross receipts from the sale of services are subject to the classification 3 retail or wholesale business tax rate, we must examine each category of such receipts.

Category 1:

² The Attorney General’s Opinion involved the proper rate to be applied to the sale of hamburger cartons to a retail restaurant when such cartons are later sold containing hamburger, to a customer of the restaurant. However, the same rationale may be applied to sales of services.

The first category of services that the Taxpayer provides are those wherein the Taxpayer's employee provides general and administrative services (i.e., a receptionist or word processor) to a client engaged in a service business (i.e., a non-seller of tangible personal property). The client's service business is different from the service business of the Taxpayer and services provided by the client are not the same services that the client is purchasing from the Taxpayer. (i.e., the client is not providing receptionist or work processing services.)

The services in this category do not meet any of the criteria set forth in the above cited statutes and rules pertaining to wholesale sales. These services are being made to customers that are engaged in a service business. They are not being resold by the customer and they are not sold to a manufacturer or processor who uses them in preparing products of tangible personal property for sale or resale. The client purchasing the services is the consumer of the services sold.

Accordingly, gross receipts from services described in Category 1 are from retail sales and are subject to the three sixteenths of one percent (3/16 of 1%) business tax rate under Tenn. Code Ann. § 67-4-709(b)(3)(A).

Category 2:

The second category of services that the Taxpayer provides are those wherein the Taxpayer's employee provides services to a client engaged in a service business (i.e., a non-seller of tangible personal property). For example, the Taxpayer's employee is a draftsman that provides such services to an architectural firm.

The services in this category do not meet any of the criteria set forth in the above cited statutes and rules pertaining to wholesale sales. These services are being made to customers that are engaged in a service business. They are not being resold by the customer. For example, an architectural firm does not sell the services of a draftsman, but rather uses and consumes such services in providing architectural services for its customers. The architectural firm sells architectural services. The services described are not used by a manufacturer or processor in preparing products of tangible personal property for sale or resale. The client purchasing the services is the consumer of the services purchased.

Therefore, gross receipts from services described in Category 2 are from retail sales and are subject to the three sixteenths of one percent (3/16 of 1%) business tax rate under Tenn. Code Ann. § 67-4-709(b)(3)(A).

Category 3:

The third category of services that the Taxpayer provides are those wherein the Taxpayer's employee provides general and administrative services to a client, other than a manufacturer, engaged in the retail or wholesale sale of tangible personal property.

The services in this category do not meet any of the criteria set forth in the above cited statutes and rules pertaining to wholesale sales. While it is clear that these sales of services are being made in the regular course of business to a licensed retailer who is engaged in the sale of tangible personal property, it is also clear that the services provided are not for resale, lease or rental. The general and administrative services are being consumed by the client to whom they are sold by the Taxpayer rather than being resold, leased or rented by such client. Thus, the sales do not meet the definition of “wholesale sale[s]” or “sale[s] at wholesale” in Tenn. Code Ann. § 67-4-702(21).

Therefore, gross receipts from services described in Category 3 are from retail sales and are subject to the three sixteenths of one percent (3/16 of 1%) business tax rate under Tenn. Code Ann. § 67-4-709(b)(3)(A).

Category 4:

The fourth category of services are those provided by the Taxpayer to a client, other than a manufacturer, engaged in the retail or wholesale sale of tangible personal property and such services involve the preparation and/or distribution of the client's goods for sale or resale. The Taxpayer gives the following examples of services in this category: (1) warehouseman; (2) forklift operator; (3) packing and shipping clerk; (4) stock clerk.

Tenn. Comp. R. & Regs. 1320-4-5-.47(2) states that “[s]ales of . . . services to a licensed retailer who may make further distributions from a central warehouse or other distribution point to others for resale shall be deemed to be wholesale sales” However, in this factual situation the Taxpayer's client is not making further distributions of the services provided. Instead, the client is using and consuming such services to prepare and/or distribute its tangible personal property for sale or resale.

Under Tenn. Comp. R. & Regs. 1320-4-5-.29(1), sales of services to processors who use such services in preparing products for resale are considered wholesale sales. Accordingly, it becomes necessary to determine whether the Taxpayer's clients are “processors”.

The term “processors” or “processing” is not defined in Tennessee's business tax statutes. Therefore, they must be given their ordinary and commonly accepted meanings. The *Beare Company v. Tennessee Department of Revenue*, 858 S.W.2d 906 at 908 (Tenn. 1993) (*citing Western Pipeline Constructors, Inc.*, 310 S.W.2d 455 at 458 (Tenn. 1958)). The Tennessee Supreme Court has defined “processing” for Tennessee sales and use tax purposes in *The Beare Company v. Tennessee Department of Revenue*, 858 S.W.2d 906 at 908 (Tenn. 1993). This decision offers considerable guidance with regard to qualifying as a “processor” for business tax purposes.

In setting out a definition of “processing”, the *Beare* court relied principally on two cases decided by the Ohio Supreme Court. First, the court quoted with approval the following definition from *Gressel Produce Co. v. Kosydar*, 297 N.E.2d 532 at 535 (Ohio 1973):

“Processing” is] essentially a transformation or conversion of materials or things into a different state or form from that in which they originally existed – the actual operation incident to changing them into marketable products.

In *Gressel* the court held that cleaning, cooling, sorting and application of oil to eggs did not constitute processing because there was no change in the state or form of the eggs.

The *Beare* court also cited *Sauder Woodworking Co. v. Limbach*, 527 N.E.2d 296 at 297 (Ohio 1998) for the proposition that the mere enhancement of the value of a product, absent a change in state or form from that in which it originally existed, does not constitute “processing”. In *Beare*, the court relied on these definitions in finding that blast freezing of food did constitute processing because the food underwent certain chemical and/or molecular changes and thus its state or form was changed. *Id.* at 909.

The *Beare* court makes it clear that a change in the state or form of the product is required in order for “processing” to occur. The Department has relied on the *Beare* analysis in holding that such activities as packaging, testing, and adjusting do not constitute processing because they do not change the state or form of the product. The fact that customers will not purchase the product unless such activities are performed is irrelevant.

The Taxpayer’s client is using and consuming such services described in Category 4 to prepare and/or distribute its tangible personal property for sale or resale. The resulting gross receipts received by the Taxpayer for such services are subject to the three sixteenths of one percent (3/16 of 1%) business tax rate under Tenn. Code Ann. § 67-4-709(b)(3)(A).

Category 5:

The fifth category of services are those wherein the Taxpayer’s employee provides general and administrative services to a client engaged in the manufacture of tangible personal property for sale at retail or wholesale.

The services in this category do not meet any of the criteria set forth in the above cited statutes and rules pertaining to wholesale sales. While it is clear that these sales of services are being made in the regular course of business to a manufacturer who is also engaged in the sale of tangible personal property, it is also clear that the services provided are not for resale, lease or rental. Thus, the sales do not meet the definition of “wholesale sale[s]” or “sale[s] at wholesale” in Tenn. Code Ann. § 67-4-702(21).

The general and administrative services are indirectly, rather than directly, related to the tangible personal property being sold by the client. Such services do not directly

facilitate the sale, or preparation for sale, of property. The general and administrative services are being consumed by the client to whom they are sold by the Taxpayer rather than being resold, leased or rented by such client.

Therefore, gross receipts from services described in Category 5 are from retail sales and are subject to the three sixteenths of one percent (3/16 of 1%) business tax rate under Tenn. Code Ann. § 67-4-709(b)(3)(A).

Category 6:

The sixth category of services that the Taxpayer provides is those wherein the employee provides services to a client engaged in the manufacture and/or process of goods for sale or resale. The Taxpayer gives the following examples of services in this category: (1) production line operator; (2) production line supervisor; (3) material handling equipment operator; (4) product designers; (5) quality control personnel; (6) packer and shipper; (7) repair and maintenance personnel to the extent that they repair or maintain manufacturing machinery; (8) assembler; (9) production equipment operator³.

The services in this category are sold to a manufacturer or processor who uses them to manufacture and/or process goods for sale or resale. Tenn. Comp. R. & Regs. 1320-4-5-.29(1) states that:

“Sales of . . . services to manufacturers and processors who . . . use the services in preparing such product for sale or resale, are considered to be sales at wholesale . . .”

The terms “manufacturers” and “processors” or “processing” are not defined in Tennessee’s business tax statutes. Therefore, they must be given their ordinary and commonly accepted meanings. The *Beare Company v. Tennessee Department of Revenue*, 858 S.W.2d 906 at 908 (Tenn. 1993) (citing *Western Pipeline Constructors, Inc.*, 310 S.W.2d 455 at 458 (Tenn. 1958)).

Since the Taxpayer’s client is in the business of changing the state or form of tangible personal property, it is clear that it qualifies as a “processor” under the *Beare* analysis discussed in Category 4 above.

For purposes of the Tennessee sales tax industrial machinery exemption, Tenn. Code Ann. § 67-6-206(b)(2) defines a “manufacturer” as “. . . one whose principal business is fabricating or processing tangible personal property for resale.” To “fabricate” is generally defined as “to make; create” or “to construct by combining or assembling diverse, typically standardized parts.” THE AMERICAN HERITAGE COLLEGE DICTIONARY 488 (3RD ed. 1997). The term “manufacture” may be defined as “to make

³ Depending on the circumstances, machinery and equipment used to perform some of the services listed may not necessarily qualify as exempt industrial machinery for Tennessee sales and use tax purposes.

from raw materials by hand or by machinery.” WEBSTER’S NINTH NEW COLLEGIATE DICTIONARY 725 (1991).

The Taxpayer’s client is a manufacturer or processor that uses the services purchased from the Taxpayer in preparing its products for sale or resale. All of the labor services described in this category appear to be directly related to manufacturing and/or processing goods for sale or resale. Accordingly, under Tenn. Comp. R. & Regs. 1320-4-5-.29(1), gross receipts from the Taxpayer’s sale of the services described in Category 6 are considered wholesale sales by Tenn. Comp. R. & Regs. 1320-4-5.29(1) and are subject to the business tax rate of three eightieths of one percent (3/80 of 1%).

Application of Tenn. Comp. R. & Regs. 1320-4-5-.37:

If the Taxpayer is primarily making wholesale sales but makes more than 20% of its sales at retail, then the wholesale sales are subject to the business tax rate of three eightieths of one percent (3/80 of 1%) and the retail sales are subject to the three sixteenths of one percent (3/16 of 1%) business tax rate.

If the Taxpayer makes 20% or less of his sales at retail, then gross receipts from all sales, both wholesale and retail are subject to the business tax rate of three eightieths of one percent (3/80 of 1%).

If the Taxpayer is primarily making retail sales but makes more than 20% of its sales at wholesale, then the retail sales are subject to the three sixteenths of one percent (3/16 of 1%) business tax rate and the wholesale sales are subject to the business tax rate of three eightieths of one percent (3/80 of 1%).

If the Taxpayer makes 20% or less of his sales at wholesale, then gross receipts from all sales, both wholesale and retail are subject to the three sixteenths of one percent (3/16 of 1%) business tax rate.

Certain Services Provided by the Taxpayer are
Exempt from the Tennessee Business Tax

Tenn. Code Ann. § 67-4-708(3)(C)(i)-(xv) exempts the following services from the Tennessee business tax:

- (i) Medical, dental, and allied health services to human beings, including sanatorium, convalescent and rest home care, but excluding services by persons engaged in the business of making dentures and artificial teeth;
- (ii) Legal services;
- (iii) Educational services offered by elementary and secondary schools, colleges, universities, professional schools and junior colleges, library and information

centers, correspondence schools, vocational schools and specialized nondegree granting schools;

(iv) Services rendered by nonprofit membership organizations operating on a nonprofit membership basis for the promotion of the interest of the members;

(v) Domestic service performed in private households;

(vi) Services furnished by nonprofit educational and research agencies;

(vii) Services by religious and charitable organizations;

(viii) Accounting, auditing and bookkeeping services;

(ix) Public utilities as defined in § 65-4-101;

(x) Services furnished by institutions which are engaged in deposit banking or closely related functions, including fiduciary activities, services furnished by persons engaged in extending credit or lending money except persons taxable under subdivision (5); services furnished by establishments engaged in the underwriting, purchase, sale or brokerage of securities on their own account or on the account of others; services furnished by exchanges, exchange clearing houses and other services allied with the exchange of securities and commodities; services furnished by investment trusts, investment companies, holding companies, and commodity trading companies;

(xi) Insurance carriers or insurance agents of any type selling or furnishing necessary services related to insurance and insurance adjustors;

(xii) Operators of residential and nonresidential buildings except hotels, motels and rooming houses;

(xiii) Lessors of the following properties: agricultural, airport, forest, mining, oil, and public utility;

(xiv) Services furnished by persons engaged in the practice of veterinary medicine, dentistry or surgery, including services involving the boarding and lodging of animals; or

(xv) Services furnished by persons engaged in the practice of architecture, engineering or land surveying[.]

The statute further states that it is the legislative intent that such exceptions shall include:

“ . . . establishments so described in the Standard Industrial Classification Index of 1972, including all supplements and amendments prepared by the bureau of the budget of the federal government, except where otherwise provided.”

It is also important to note that Tenn. Code Ann. § 67-4-708 classifies a business according to its “dominant business activity,” which is defined by Tenn. Code Ann. § 67-4-702(4) to mean the business activity that is the business’ major and principal source of gross sales at retail and the major and principal source of gross sales at wholesale. The fact that sales may be made at both wholesale and retail has no effect in determining the dominant business activity. Tenn. Comp. R. & Regs. 1320-4-5-.15.

However, the dominant business activity of a taxpayer is relevant only in determining which of the classifications specified in Tenn. Code Ann. § 67-4-708 applies to that particular taxpayer, which, in turn, determines the rate of tax applicable and the due date of the taxpayer’s business tax return. *Hermitage Memorial Gardens Mausoleum and Memorial Chapel, Inc. v. Dunn et al.*, 541 S.W.2d 147 at 149 (Tenn. 1976). In other words, a taxpayer’s dominant business activity does not have to be the business activity described in the exemptions enumerated in Tenn. Code Ann. § 67-4-708(3)(C)(i)-(xv) in order for the exemption to apply. Likewise, if the exemption applies, the taxpayer is exempt only as to its gross receipts from that particular business activity. Gross receipts from other non-exempt activities are subject to the business tax.

In *Aabakus, Incorporated v. Huddleston*, WL 548148 (Tenn. Ct. App. 1996) the Tennessee Court of Appeals considered the applicability of the business tax exemptions set forth in Tenn. Code Ann. § 67-4-708(3)(C)(i)-(xv).

Aabakus provided human resource management services to its clients and received a lump sum fee for agreeing to perform such services. In order to do this, Aabakus became the on paper “employer” of its clients’ employees. The employees continued to perform the same work and remained under the client’s direct supervision.

Each payday, clients of Aabakus provided hours worked and rates of pay for each employee along with a wire transfer to cover the gross payroll, all applicable taxes, insurance premiums and Aabakus’s service fee. Aabakus would then prepare payroll checks, pay taxes and insurance premiums, and file all necessary reports for each client. Funds remaining in the hands of Aabakus represented Aabakus’s service fees. Aabakus claimed to be exempt from the business tax because it provided exempt accounting, auditing, and bookkeeping services.

The court found that the dominant business activity of Aabakus was much more than the exempt services that it provided. *Id.* 1. The service fee paid by each client was based on all the services performed by Aabakus. Thus, the accounting, auditing and bookkeeping services provided could not be separated from the other human resource functions performed. The accounting, auditing and bookkeeping services performed were not separate activities generating a separate share of the “value added” by Aabakus’s business, but rather were part-and-parcel of the entire service package

performed by Aabakus. No single function or service could be viewed as incidental to others. *Id.* at 5.

In other words, the dominant business activity of Aabakus was not accounting or some other exempt activity described in the Standard Industrial Classification Index of 1972, which, at the time of the Aabakus decision had been superseded by the Standard Industrial Classification Manual of 1987.

The court went on to say that Aabakus's services were a combination of the various SIC industry classifications that would be classified, if at all, under one of the miscellaneous industry categories. Its functions were much broader than the "payroll accounting services" then classified under SIC industry number 8721. Its services might more properly have been classified as management consulting included in industry code number 8742. *Id.* at 5. Thus, Aabakus could not qualify for a complete business tax exemption.

Aabakus did not provide its clients with simple bookkeeping services nor did it provide its clients with permanent or temporary employees. Thus, its business tax liability is based on the fees that it charges for its personnel management services. *Id.* at 6.

Unlike Aabakus, the Taxpayer is providing its clients with temporary employees, some of whom exclusively perform services exempt from the business tax under Tenn. Code Ann. § 67-4-708(3)(C)(i)-(xv). The fees that the Taxpayer receives for the services that it provides are based on the classification of each of its employees and the services provided by each employee. Also, unlike Aabakus, the Taxpayer can separately account for fees based on the identity of the customer and the nature of the services provided that customer.

As a whole, the Taxpayer's dominant business activity of providing its clients with the services of temporary employees does not qualify for any of the exemptions enumerated in Tenn. Code Ann. § 67-4-708(3)(C)(i)-(xv). However, the Taxpayer's dominant business activity is relevant only for determining which of the 5 classifications set forth in Tenn. Code Ann. § 67-4-708 that the Taxpayer falls within. *Hermitage Memorial Gardens Mausoleum and Memorial Chapel, Inc. v. Dunn et al.*, 541 S.W.2d 147 at 149 (Tenn. 1976). The determination of whether an exempt service is being provided is made based on the specific service that the Taxpayer provides rather than the aggregate of all services provided. In doing this, the *Aabakus* decision makes it clear that the Taxpayer must be able to segregate its gross receipts from fees so that it is clear as to which fees are generated by the providing of a particular employee that exclusively performs one of the activities exempted by Tenn. Code Ann. § 67-4-708(3)(C)(i)-(xv).

For example, if the Taxpayer provides a client with several temporary employees, one of which exclusively performs exempt accounting, auditing and bookkeeping services, and the fee received for the services of this employee can be segregated and identified as specifically generated from the services of that particular employee rather than from

the other employees who do not provide exempt services, then the fee is exempt from the Tennessee business tax.

On the other hand, for example, if the Taxpayer were to provide a client with several temporary employees that all perform a variety of services, including accounting services, and is paid a lump sum fee for the services of these employees as a whole, none of the fee that the Taxpayer receives would be exempt from the Tennessee business tax.

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APPROVED: Loren L. Chumley, Commissioner

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